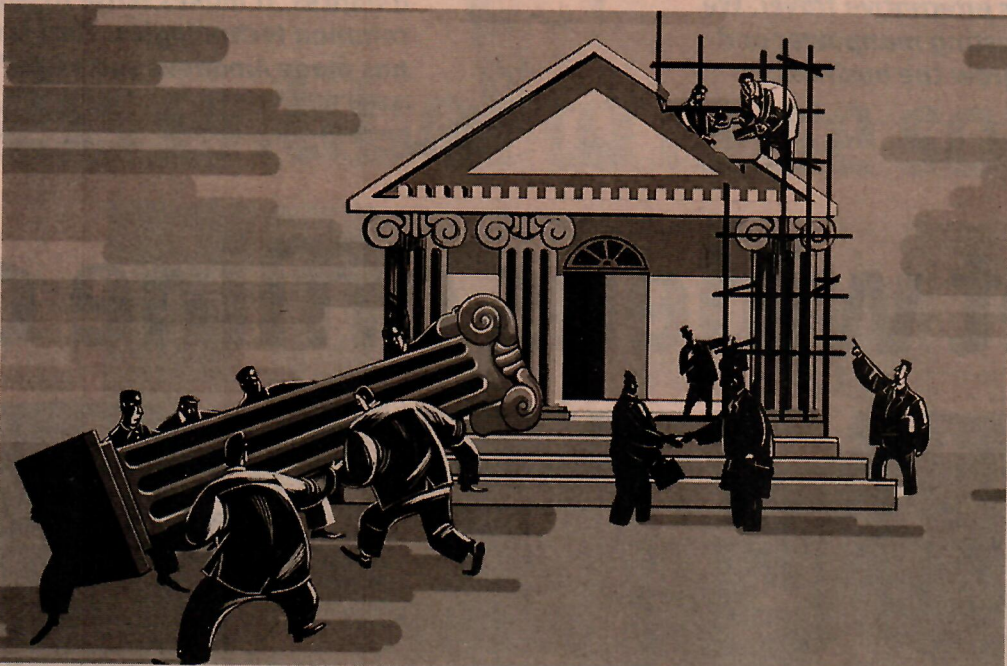


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How can ARCs help solve the banking crisis?

For an ARC to make sense, it must be a simple private equity fund. The notion of the RBI writing regulations governing ARCs was wrong

There is much interest in the role of asset reconstruction companies (ARCs) in solving India's banking crisis. In order to do this, we need to remedy the basic mistakes that have been made in the regulation of ARCs to date. We must ask: Why will an ARC fare better than a bank in dealing with an NPA? Why will a bank accept the bad news by selling assets to an ARC?

Banks in India fare poorly in giving loans and in dealing with an NPA. Why do we believe that an ARC will work better? Both groups of firms will hire from the same workforce.

For an ARC to make sense, it must be a simple private equity fund. There would be managers and investors. The managers would convince investors to commit capital to the venture. The ARC would buy a bad loan by paying hard cash. It would then process the bad asset. The profits that it makes would go back to its investors, with performance-linked payments to the managers. The managers of the ARC would use tools like the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI) and Insolvency and Bankruptcy Code (IBC) in order to realise the maximal value. Any public sector ARC is a confused concept as it would not have this incentive structure.

Do private equity funds require regulation? Let's walk through the FSLRC (Financial Sector

Legislative Reforms Commission) checklist. Private equity funds have no retail investors, so there is no consumer protection problem. They make no promises, so there is no micro-prudential regulation problem. They are not large enough to rock the economy, so there is no need for systemic risk regulation. With the three justifications for regulation out of the way, private equity funds should be unregulated.

Unfortunately, the notion of an ARC in India today is a mess. The ARC does not pay cash. It pays the banks using pieces of paper. The entanglement of the bank does not end when the asset is sold. There are intrusive ARC regulations which are riddled with conceptual confusion. These mistakes have choked the ARC concept at birth.

Let's turn to the bank. A bank has to decide that it will sell an asset. It would run an auction, and an ARC (or some other private person) would be the highest bidder. This auction would be simple as it would just involve paying

hard cash. Once the asset is sold, the bank achieves closure.

When an asset with a nominal value of ₹100 is sold for ₹30, the bank has to take a loss of ₹70 in its profit and loss statement. To the extent that it has started writing down the value of the asset, the hit would be smaller.

If a loss of ₹70 is experienced when an asset is

sold for ₹30, this hurts. Banks are keen to hide bad news. Every manager, every CEO of a bank is keen to avoid this recognition of bad news. This is where banking regulation must come in.

Bank regulation has to do two things. First, the RBI should insist that there should be a clean sale of the NPA in exchange for cash. The shell game of paying for an NPA using pieces of paper should be stopped.

Second, the RBI should force banks to rapidly mark down the value of an asset once it has gone bad. The value of the asset on the books of the bank should go to zero fairly quickly. The bank should face the internal question as follows: "This asset has got a value of near 0 in our books, now are we better off extracting value from it on our own, or are we better off auctioning it into the market and getting some hard cash in return?" When the problem is posed like this, banks will make rational decisions.

What is required in banking regulation is not much different from basic notions of accounting under the International Financial Reporting Standards (IFRS). Assets must be carried at an estimate of prospective market value, and conservative accounting practices must be followed, through which the accounting value of the asset is shaded on the lower side. The simple application of the IFRS would go a long way in addressing the failures of banking regulation in India.

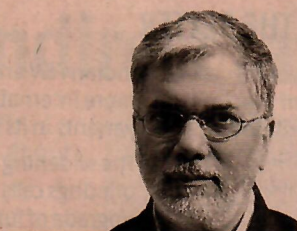
We must note that both elements of regulation — forcing sale in exchange for cash only, and forcing a very rapid mark-down of the value of NPAs — only pertain to regulating banks. There is no role for the RBI, or any financial regulator, in the working of private equity funds such as ARCs. The notion of the RBI writing regulations governing ARCs was wrong.

Once we get the basic concepts right, the ARC industry will work. There is quasi-infinite capital available in the global financial system from investors in ARCs. Hence, the scale on which this operates can be very large. But this requires addressing one more policy mistake: The capital controls that hinder foreign capital coming into ARCs. We will be better off if the term ARC is abolished, and all we have are private equity funds.

The ARC industry in India has failed. This does not mean that the government needs to start an ARC. We need to diagnose the policy failures through which the ARC industry failed. The policy failure is in the concept that the ARC is an RBI-regulated person and the RBI regulations that shape the life of the ARC to a great extent. This was done as part of the overall effort to hide bad news about banks. That approach has failed. It has given us recurring banking crises, and it must be reversed.

A long list of mistakes in banking regulation have given us recurrent banking crises. The status quo is nice for the RBI and banks, but it is bad for the taxpayer and the economy. We need to address these mistakes at the root cause. This calls for strengthening intellectual capacity at the RBI, and revamping the legal foundations of the RBI and of banking regulation, so as to break with bank-friendly bank regulation.

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